

EARNINGS, VOLUME TRENDS AND PROSPECTS

Trust department earnings is a confusing subject, primarily because there is no generally accepted or standardized cost accounting system designed for analysis of trust income and expense. The fee and other direct income of a particular department is easily measured, with some banks using the accrual and others the cash method of accounting. A more difficult problem is accounting for expense. Some sophisticated banks allocate a proportional share of occupancy expense to its trust department; yet, there is more than one way of determining the base for allocation. Two of the more common are floor space and salary. Some banks segregate portions of legal, data processing, auditing and executive services expenses in allocating trust expense. Although it is generally recognized that a trust department generates other more lucrative business for its institution, there is little evidence indicating bankers seriously attempt estimation of this benefit. However, some departments are allocated an income credit based upon the volume of own-bank deposits generated by trust accounts.

In an effort to evaluate trust department earnings, the Federal Financial Institutions Examination Council (FFIEC) adopted a formula for measuring expense, and a deposit credit. The Uniform Interagency Trust Rating System UITRS) provides examiners with these formula and instructions for application in instances where banks do not segregate direct trust expense, allocate other applicable bank overhead, or indicate a deposit credit. A discussion of these formulae will be found at the end of this Section of the Manual.

The Corporation does not expect each trust department to be profitable, however, it does expect that each bank operating a trust department be aware of its trust department's contribution or cost to the operating earnings of the bank. Banks operating trust departments should attempt to measure direct and indirect trust income and expense. Realistic budgets should be established and periodically reviewed, with significant deviations of actual performance from budget expectations brought to the attention of senior bank management.

Examiners are obligated to discuss trust budgets

and performance with bank as well as trust management. Examiners should understand and evaluate a bank's policy regarding the opening performance and prospects of the trust department. In situations where the bank has no clear policy or understanding of these matters, the examiner should make appropriate comments in the report of examination regarding bank policies. Additionally, examiners are to rate trust earnings, volume trends and prospects under the UITRS. Following is a discussion of the applicable criteria.

(1) Scope - This area encompasses an evaluation of the department's operating results and earning trends and the probable effect thereon of the volume and character of present and anticipated future business.

(2) Coverage - Factors specifically considered include: Management's attitude toward growth and new business development; Dependency upon nonrecurring fees and commissions; Unusual features regarding composition of business, fee schedules and effects of charge-offs or compromise actions; and New business development efforts, including such factors as types of business solicited, market potential, advertising, competition, and relationships with local organizations.

(3) Rating Guidelines

Rating "1" - Operations in each of the past five years have been profitable without credit for deposit balances; business volume and prospects favor a continuation of this trend.

Rating "2" - Operating results for the past five years reflect, on average, a net profit without credit from deposit balances; although an occasional loss year is possible, business volume and prospects favor a continuation of five-year average profitability.

Rating "3" - Operations are generally unprofitable, but operating losses, when averaged over the previous five-year period, do not exceed the average credit for deposit balances; gross revenues are generally sufficient to permit recovery of salary expenses and a continuation of this trend is likely.

Rating "4" - Operating losses, when averaged over

the previous five-year period, do not exceed the average credit for deposit balances, but gross revenues are generally not sufficient to permit recovery of salary expenses; business volume and prospects suggest a continuation of this trend. Rating "5" - Operating losses consistently exceed the credit for deposit balances; no reversal of this trend appears likely.

In applying the rating guidelines, emphasis will not only be placed upon existing levels of profitability or unprofitability but also the department's new business development efforts, competitive and other market factors in order to determine if current earnings trends are likely to continue. For example, a department that has been clearly profitable in each of the past five years on the basis of operations may have allowed its performance or new business efforts to deteriorate to the point where serious doubts exist that profitability can be sustained. In this case, a rating one step lower than that called for by application of the guidelines may be appropriate. Conversely, a department which has narrowed its losses over the past five years may warrant a rating one step above, where volume trends and prospects suggest continuing improvement in the earnings trend.

In the case of smaller departments where expenses are not allocated, it will be necessary to estimate both total expenses and the credit for deposit balances. For this purpose, salary expenses are determined by adjusting the salaries of individuals engaged in trust activities by the percentage of time devoted to trust activities. The adjusted salary expenses figure is then multiplied by 150% to arrive at a total expense figure. On the other hand, for departments which allocate direct expenses but not indirect expenses (e.g., overhead expenses, executive supervision, etc.), the total indirect expenses should be stated at 30% of direct expenses in arriving at a total expense figure. The credit for deposit balances where not allocated, may be determined by multiplying the average demand balance of trust department funds (using quarterly balances) by the average Federal funds rate for the year.

While it is recognized the percentages to be applied in arriving at a total expense figure are somewhat arbitrary, their use is encouraged as a means of developing uniformity in this important area. Discretion may be used to apply a greater or

lesser percentage if warranted by the circumstances of a particular department.

Some small part-time departments operate at a loss and are in business primarily for the purpose of providing full banking services to customers. Discretion may be used to rate Earnings, Volume Trends and Prospects as "4" without regard to the credit for deposit balances.